Money Matters

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Skloff Financial Group Question of the Month

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Q: We read ‘How a Gift Can Be a Tax Dream or a Tax Nightmare’ Part 1 and Part 2. We also read ‘How To (Legally) Avoid Taxes When Selling Your Home’ Part 1, Part 2 and Part 3. Furthermore, we read ‘How Gifting Versus Selling Your Home Can Be a Tax Dream or a Tax Nightmare’ Part 1, Part 2 and Part 3. Then, we read ‘How a Step-Up in Basis Can Be a Tax Dream’ Part 1, Part 2 and Part 3. Lastly, we read ‘How Community Property States Versus Separate Property States Can Be a Tax Dream or a Tax Nightmare’ Part 1, Part 2 and Part 3. Can you provide additional strategies that optimize taxes in separate property states?

The Problem – Understanding Tax Strategies in Separate Property States Can Be Confusing
What’s mine is yours and what’s yours is mine, in marriage, right? Like many financial questions, the answer depends on the circumstances.

The Solution – Understanding Tax Strategies in Separate Property States
Whether it is estate planning, marital planning or tax planning, understanding tax strategies in separate property states is critically important to develop the best plan. Let’s examine tax planning strategies below.

Boomerang Rule - Gifts Within One Year of Death. According to Internal Revenue Code Section 1014(e), there is no date of death tax basis adjustment for property received from the decedent if the property was gifted to the decedent within one year prior to death. Essentially, the IRS does not want you to gift appreciated assets to some who is on the verge of dying, so they can name you as the beneficiary and you can gain a quick step-up in basis.

Separate Property States With Tax Planning. Let’s look at an example of a younger, healthy spouse and an older, terminally ill spouse with a two-year life expectancy. Prior to their marriage each purchased $100,000 of a stock that is now worth $1,000,000. To celebrate their marriage 30 years ago, they purchased $100,000 of a stock now worth $1,000,000. Let’s examine the tax implications of selling the stock for $1,000,000 immediately after the terminally ill spouse’s death, utilizing tax planning strategies.

Healthy Spouse Account. The healthy spouse transfers their $1,000,000 account in their own name to the terminally ill spouse’s account in the terminally ill spouse’s name. Based on the terminally ill spouse dying less than one year later, the surviving spouse does **not receive a step-up in basis**. According to Internal Revenue Code Section 1014(e), the costs basis remains unchanged. The surviving spouse can immediately sell the stock for $1,000,000 and will be left with $785,800 net of taxes. The calculation is as follows: ($1,000,000 - $100,000) – ($900,000 X 20%) – ($900,000 X 3.8%) = $785,800 – **a tax nightmare**. In this example, the surviving spouse was subject to a 20% capital gain rate and a 3.8% net investment income tax (NIIT). See the first red (danger zone) section of the table below.
If the terminally ill spouse dies more than one year after the transfer, the surviving spouse receives a **full step-up in basis** and can sell the stock for $1,000,000 and pay no taxes – **a tax dream**. See the first green (ultra safe zone) section of the table below.

Joint Account. The healthy spouse transfers their $1,000,000 joint account to the terminally ill spouse’s account in the terminally ill spouse’s name. Based on the terminally ill spouse dying less than one year later and the ‘Boomerang Rule’, the surviving spouse only receives a **50% step-up in basis**. The surviving spouse can immediately sell the stock for $1,000,000 and will be left with $892,900 net of taxes. The calculation is as follows: ($1,000,000 - $550,000) – ($450,000 X 20%) – ($450,000 X 3.8%) = $892,900 – **a tax nightmare**. In this example, the surviving spouse was subject to a 20% capital gain rate and a 3.8% net investment income tax (NIIT). See the yellow (danger zone) section of the table below.
If the terminally ill spouse dies more than one year after the transfer, the surviving spouse receives a **full step-up in basis** and can sell the stock for $1,000,000 and pay no taxes – **a tax dream**. See the second green (ultra safe zone) section of the table below.

Terminally Ill Spouse Account. The surviving spouse receives a **full step-up in basis**. The surviving spouse can immediately sell the stock for $1,000,000 and pay no taxes – **a tax dream**. See the third green (ultra safe zone) section of the table below.

Step-Up in Basis in a Separate Property State					
	Healthy Spouse Transfers to Terminally Ill Spouse Terminally Ill Spouse Dies in Less Than 1 Year	Healthy Spouse Transfers to Terminally Ill Spouse Terminally Ill Spouse Dies in More Than 1 Year	Joint Account Transferred to Terminally Ill Spouse Terminally Ill Spouse Dies in Less Than 1 Year	Joint Account Transferred to Terminally Ill Spouse Terminally Ill Spouse Dies in More Than 1 Year	Terminally Ill Spouse Account Dies
Value on Date of Death	**$ 1,000,000**	**$ 1,000,000**	**$ 1,000,000**	**$ 1,000,000**	**$ 1,000,000**
Cost of Purchased Stock	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Surviving Spouse's Share of Cost Basis	$ 100,000	$ 0	$ 50,000	$ 0	$ 0
Additional Basis if Applicable	$ 0	$ 900,000	$ 500,000	$ 900,000	$ 900,000
Basis After Step-Up in Basis if Applicable	**$ 100,000**	**$ 1,000,000**	**$ 550,000**	**$ 1,000,000**	**$ 1,000,000**
Long Term Capital Gains Tax 20%	$ 180,000	$ 0	$ 90,000	$ 0	$ 0
Net Investment Income Tax (NIIT) 3.8%	$ 34,200	$ 0	$ 17,100	$ 0	$ 0
Total Taxes	$ 214,200	$ 0	$ 107,100	$ 0	$ 0
Proceeds Net of Taxes After Immediate Sale	**$ 785,800**	**$ 1,000,000**	**$ 892,900**	**$ 1,000,000**	**$ 1,000,000**

Action Steps
Work closely with your Registered Investment Adviser (RIA) to reduce your taxes, and grow and preserve your wealth.

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